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Subject: Comments on the OECD Paper, Transfer Pricing Comparability Data and Developing Countries, as released on March 11th, 2014.

Dear Sirs,

On March 11th, 2014, the OECD published the Paper on Transfer Pricing Comparability Data and Developing Countries (hereinafter the "paper"), mentioning on its website that written comments and suggestions on this paper should be sent by April 11th, 2014 by interested parties.

The purpose of this paper is to satisfy the G8 request to "*find ways to address the concerns expressed by developing countries on the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively*". Indeed, we are increasingly confronted to the difficulty of the lack of reliable data to assist in particular mid-sized Multinational Enterprises (hereinafter "MNEs") complying with the arm's length principle in their cross-border transactions involving such countries. In this context, we examined the paper with great interest and trust that we will be able to provide you with constructive suggestions.

According to the above, we are most thankful for the opportunity given by the OECD to participate in this project and hope you will find useful remarks in our comments here below.

Please do not hesitate to contact us should you require any clarification on those comments that are sent on behalf of the Rödl & Partner Global Transfer Pricing Group.

Best regards,

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A. INTRODUCTION

As indicated in the executive summary of the paper, applying the "*arm's length principle to review* [or establish] *transfer prices* [or remunerations] *set in transactions between associated enterprises often requires a comparison to be made between these prices* [or remunerations] *and the prices set in*" comparable uncontrolled transactions.

The executive summary highlights the difficulties encountered in identifying available and reliable financial data on uncontrolled transactions that can be used for comparisons, before discussing four possible approaches to resolve this issue. Our comments below follow the structure of the paper regarding these possible approaches:

- **Expanding access** to data sources for comparables (B.);
- **More effective use** of data sources for comparables (C.);
- Approaches to **reduce reliance on direct comparables** (D.); and
- **Advance pricing agreements** and **mutual agreement proceedings** (E.).

Nevertheless and as a preliminary remark, it is our opinion that various approaches discussed do not only affect taxpayers/administrations from developing countries, but also taxpayers/administrations from developed countries, especially when the management of the transfer prices is centralized in the head offices of a MNE acting or planning to act in developing countries. In this regard, global guidance would be welcomed on, for instance: Improvement on public access to financial data on comparables, broader acceptance of additive approaches, greater flexibility in terms of search criteria, use of the foreign counterparty to test the arm's length remuneration, safe harbour rules, MAP, etc.

B. EXPANDING ACCESS TO DATA SOURCES FOR COMPARABLES

The beginning of paragraph 13 of the paper mentions that "*in the absence of other comparables, commercial databases may provide a starting point for setting and auditing transfer prices*". Nevertheless, before analyzing the use and weaknesses of such commercial databases, we would suggest providing more guidance regarding the acceptability of **additive approaches** (paragraph 3.41 of the OECD TPG[1]). In this regard, MNEs engaged in developing countries may be able to set up a list of third parties that carry out comparable transactions, for example based on an initial business plan and/or market analysis, without turning up to commercial databases. As a consequence, since a wider acceptance of such approaches could highly help reducing the difficulties mentioned in the paper, it would be advisable to further implement them in practice.

As discussed in the OECD draft, different commercial databases have been accepted as reliable comparable sources by tax authorities, in contrast others have proven essential weaknesses when it comes to find comparables for an appropriate benchmark study. We would appreciate, if the providers of such databases could, for the benefit of both developed and developing countries, be encouraged to take the necessary steps in improving on the one hand the quality of the data contained and on the other hand the coverage and access to such

[1] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010 (hereinafter "OECD TPG").

information. However, we think that it may be very difficult to define expedient stimuli for suppliers of data bases to improve their benefit for developing countries. Fiscal incentives might be an option.

In relation to the expansion of the access to data sources for comparables, paragraph 13 of the paper indicates that a "*number of commercial databases are available to identify and extract financial data* […]". In this context, both taxpayers and tax authorities may, in the same market and for similar transactions, employ **different commercial databases** that can naturally lead to slightly different results. Apart from the inefficiencies created by such a situation, this would create distrusts between the parties and in particular, the results obtained by the tested party may be challenged by the tax authority arguing that the database and/or comparables are not reliable. Consequently, we would suggest an earlier disclosure on the concrete (commercial) databases generally employed by the tax authorities.

Should the tax authorities be reluctant to inform on the (commercial) databases at their disposal, it would be advisable, from an OECD perspective, to inform the MNEs on the commercial databases that contain reliable information that may be employed for comparability and economic analysis.

Paragraphs 15 and 16 of the report present the possible introduction of an obligation to file statutory accounts as a solution to obtaining publically available data. Although the reporting of statutory accounts has been legally imposed in several countries, the access to information on a case by case basis or limited access according to the type of company still faces serious limitations.

Broadening or strengthening the **obligation to file statutory accounts** may not be desired and difficult to implement in some local legislations. Nonetheless, an international harmonization of the obligations to file statutory accounts at company registers has to be seen positively.

However, we trust that the OECD should primarily focus on the improvement of public access to statutory accounts (e.g. by providing or improving IT infrastructure) to broaden and increase the quality of comparability data under the effective obligation rules instead of trying to strengthen the obligation to file statutory accounts with the company registrar in principal. That might also attract commercial database providers to improve their offers.

Public access to comparability data is the basis of arm's length testing and for this reason the improvement of the public availability of statutory accounts should be a core objective. As a consequence of an enhanced quality and quantity of public available data, the amount of direct comparables increases. Accordingly, more identifiable direct comparables reduce the necessity to take further steps towards less comparable data, e.g. from other sources, countries, industries etc., providing the best way of getting around the problems of e.g. comparable adjustments.

After discussing the possible obligation for companies to file statutory accounts and making them easily available to the public through registers, the paper finally raises the question of **secret comparables**. According to its paragraph 17, even "*if easy public availability of statutory accounts is not possible, the tax administrations of developing countries with a significant number of sizeable independent companies will have access to their financial statements*". The paper then recognizes that the use of secret comparables is contentious but a "*distinction could possibly be drawn in practice between use for risk evaluation purposes (i.e. identifying a taxpayer for possible audit) and for making a transfer pricing adjustment*".

In this regard, we would like to stress that paragraph 3.36 of the OECD TPG already indicates that "*it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able* […] *to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts*".

By taking the previous provisions into account, it is first critical that the tax administrations of developing countries disclose, in an early phase, detailed information on the methodology applied to set, for example, a targeted arm's length return (e.g. region, market, industry, number of comparables, statistical calculation, adjustments applied, etc.).

Then, transparency on the criteria applied by the tax administrations in an early risk assessment phase could encourage MNEs to perform their own comparable searches based on a similar methodology. Therefore, this process could improve the efficiency when administering Transfer Pricing.

Despite of the above, employing secret comparables "per se" in the risk assessment phase can create situations not desirable according to the OECD TPG. Therefore, it has to be clearly mentioned that tax authorities are not allowed to perform a primary adjustment on data obtained from secret comparables unless the methodology employed is disclosed in details. Additionally and as a principle, if the taxpayer provides its own risk assessment, this should serve as a basis for the discussion in the tax audit phase. Otherwise, there is a relevant risk that tax authorities might not will to deviate from their preliminary results and that taxpayer encounter obstacles to defend their own assessment. To conclude we would stand back from the use of secret comparables.

C. MORE EFFECTIVE USE OF DATA SOURCES FOR COMPARABLES

Paragraph 19 of the paper highlights that, in certain markets and industries, information on independent transactions may be limited. In those situations, the OECD TPG recognizes that practical solutions with a certain degree of compromise should be analyzed. In this context, the paper mentions that an option would be to broaden "*the search for comparable to uncontrolled transactions in the same industry but in other geographic market*".

Regarding the possible and future development of soft-rules regarding this central aspect of the comparability data in developing countries, we would first make a preliminary remark and then, suggest considering other search criteria.

As a previous question to the acceptance of comparable transactions carried out by entities located in other geographic markets, it would be very useful to have more guidance on cases where little information on highly comparable entities to the tested party is available in the same geographic markets. It is in this case difficult to take a straight forward decision for the MNE or for the tested party to eventually employ this information or, conversely, to search for comparable transaction in other geographic markets.

One practical solution could be, as an example only, to accept the use of minimum and maximum of values obtained from few but highly comparable entities in the same market instead of interquartile range calculated from a wider set of less comparable entities.

On another hand, enlarging the geographic market is generally the first option considered to solve the problem of a lack of data on comparable transactions/entities. Nevertheless, **other search criteria** should be further examined as they could be of practical help to fill in the lack

of data on independent transactions in certain markets, as well as to enhance the use of existing sources of data for comparables[2]. Such other search criteria are:

- Independence criteria (e.g. acceptance of entities considered as independent if the participation threshold from shareholders and with subsidiaries is, directly or indirectly, below 50%);
- Financial year under analysis (e.g. wider use of multiple-years analysis);
- Activity codes (e.g. recognition of activity codes from other markets if certain conditions are met); and
- Size/volume of transactions of the comparable entities (e.g. recognition that bigger or smaller entities may face similar market business risks and that, under certain conditions, their size might not affect the profitability level);
- Etc.

Additionally, paragraph 21 of the paper deals with **country adjustments** indicating that they "*could be gathered and additional guidance developed*". Indeed, when assessing the arm's length remuneration of parties located in developing countries (but also in developed countries under certain circumstances) performing country adjustments could improve the more effective use of data sources. Nevertheless, country adjustments depend on a great variety of aspects and factors. Consequently, further general guidance on these aspects, determining cases where country adjustments should be performed (e.g. different labor costs, transportation costs, country risk, etc.) and subsequently, the logical and mathematical process when conducting them should be defined and developed.

In our opinion, country adjustments mainly rise the question of the local specific advantages (hereinafter "LSA") and market premium. As mentioned in the paper, the United Nations Practical Manual on Transfer Pricing for Developing Countries (hereinafter the "Practical Manual") already provides examples of countries that apply such adjustments "*but does not provide guidance on such adjustments*". However, Chapter 10.3.3 of the Practical Manual presents a clear case of a Chinese taxpayer's cost base, together with the determined adjusted arm's length mark-up for this taxpayer. Accordingly, the OECD should internally analyze whether and how such adjustments could be recognized by tax authorities in other jurisdictions (e.g. how to measure the relevant elements), especially in developed countries. Depending on the results of this analysis, specific recommendations should be introduced in the OECD TPG to reduce the risk of double taxation.

Paragraph 22 of the paper discusses the possibility of using the **foreign counterparty** as the tested party to test its return earned. Testing the remuneration of the foreign counterparty is an option that would help MNEs complying with the arm's length principle should it be very difficult or almost impossible to identify local comparables in developing countries. Other requirements may have to be fulfilled before accepting such an approach. In this regard, it is relevant to note that in an increasing number of audits, tax authorities are willing to understand the profitability of the foreign counterparty, together with the assessment of the tested party's financial results (e.g. "two-sided analysis").

Nevertheless, we consider that this solution will have very low acceptance in practice (e.g. tax authorities willing to mainly assess the value obtained the tested party's jurisdictions, "tested

[2] Please note that paragraph 18 indirectly mentions this issue: "*Inappropriately specified search criteria may return overly broad results that incorporate inappropriate comparables*".

party principle" is already well recognized in almost all OECD's jurisdictions, etc.) and will find practical difficulties in its implementation (e.g. entrepreneur with a great variety of different types of transactions and/or using relevant intangible assets in the foreign country, etc.).

D. APPROACHES TO REDUCE RELIANCE ON DIRECT COMPARABLES

Rödl & Partner agrees with the view mentioned in paragraph 24 of the paper that transfer prices must be set by taxpayers and audited by tax administrations based on the most comparable data available even if such information is difficult to identify and/or to obtain. In this sense, a replacement of the **arm's length principle** by formula based systems is not a realistic option as the "*arm's length principle* […] *provides the closest approximation of the working of the open market*"[3] and among several reasons, a great majority of OECD and non-OECD countries have adopted the arm's length standard. Furthermore, the "*experience under the arm's length principle has become sufficiently broad and sophisticated to establish a substantial body of common understanding among the business community and tax administrations.* […] *In fact, no legitimate or realistic alternative to the arm's length principle has emerged.*" Maintaining the arm's length principle should be a core MNEs/tax administrations' objective, despite of the lack or available and/or reliable comparability data in developing countries.

In accordance with the assessment set in the preceding paragraph, income allocation systems such as a formulary apportionment "*would not be acceptable in theory, implementation, or practice*"[4] and should not be considered further (compare Chapter I, C of the OECD TPG).

The application of the profit split method has increasingly become a preferred method to test the compliance of the arm's length principle in many developing countries. Nevertheless, concerning other alternative approaches - such as the **profit split** and/or a **global value chain analysis** - it is often times challenging to assess the correct level of contribution of a tested company in the whole process of business operations of a MNE. Despite the fact that the mentioned methods are already accepted by several tax administrations and in addition the OECD TPG already gives guidance e.g. in regards to the profit split methods in Chapter II, it will be necessary to address the flaws of these alternative approaches. Otherwise, the application of e.g. the value chain analysis may lead under certain conditions to transfer prices between affiliated enterprises which are not in line with the arm´s length principle. Additionally, a formula profit sharing based on a weighted value chain contribution analysis would create major risks in case of an outcome testing approach. It will not consider the actually realized risks and chances.

Paragraph 26 of the paper mentions that the "***careful use of safe harbours*** *[…] can reduce the need to obtain comparables for specific transactions*". In this sense, for specific transactions especially (e.g. low-risk manufacturing/distribution activities, low-value added services, plain vanilla financial operations, etc.), safe harbours rules, if accepted by both the country where the tested party and the foreign counterparty are located, might be a useful and cost-reducing tool to satisfy the arm's length principle. Moreover, such rules in developing countries could facilitate the attractiveness of their jurisdictions as a place of business, since MNEs who determine their transfer prices based on safe harbours provisions will efficiently reduce their transfer pricing risks.

Nevertheless, several prerequisites should be established in this area:

[3] Paragraph 1.14, OECD TPG.
[4] Paragraph 1.15, OECD TPG.

- The functions performed in the frame of the relevant transaction are routine functions;
- Safe harbour rules shall reflect comparable data that have been applied between third parties and has to be broadly unaffected by political interests; and
- Setting safe harbour rules should not immediately cause tax adjustments, if taxpayers do not apply safe harbours in respect to business relations with affiliated companies. The safe harbour should not constitute as a method "primus inter pares". Instead, safe harbour should only be one alternative approach next to e.g. the transfer pricing methods that are already described in Chapter II of the OECD TPG.

In this regards, to prevent a rejection of the arm's length principle, further general guidance on setting (bilateral / unilateral) safe harbour rules and development of guideposts regarding the international coordination of such rules would be highly appreciated.

Mid-sized MNEs are particularly concerned with the administrative burden, together with their objective to efficiently reduce the risks of primary adjustments. For this reason, instead of evaluating a variety of alternative approaches and taking into account that transfer prices are "*not an exact science*"[5], it might, in case no appropriate internal comparables or publicly available external comparables are identifiable, a viable way forward to give taxpayers the opportunity to set transfer prices based on the so called "**hypothetical arm's length principle**". According to this principle, related parties have to determine their prices with the same prudent business management principle as those that govern the process in uncontrolled situations in case no data on comparable transactions are available. Finally, the price setting would simulate the price setting process between unrelated parties following economical rationales and is highly consistent with the economic criteria beyond the transaction.

E. ADVANCE PRICING AGREEMENTS AND MUTUAL AGREEMENT PROCEEDING

APA is an alternative to achieve in advance certainty regarding the transfer pricing for both tax administrations and taxpayers. In most cases, information exchange between taxpayers and tax administrations is essential for a successful APA, and usually, it is the taxpayer who has to prepare and submit the relevant information, including business plan and other documents of confidentiality concern, for disclosure and explanation purpose to tax administrations. The question to be raised herein is that, if an APA application fails in the end, the taxpayers' position in the future tax compliance will be impacted which most of taxpayers are reluctant to see. Therefore, practical guidelines shall be provided to resolve the problem of how to still balance the positions between taxpayers and tax administrations even after an APA application fails.

As indicated in paragraph 30 and 31 of the paper, both an APA program and negotiation between taxpayers and tax administrations to resolve impending or in-progress transfer pricing disputes require access to skilled and experienced human resources from sides of both taxpayers and tax administrations. Currently, very few professionals are identifiable in the tax administrations of developing countries. More training and courses are recommended to be sponsored for developing countries, both online courses or regular organized trainings in one developing country participated by trainees from other developing countries will be very much helpful. Similarly, the competing demand for scarce human resources between APA and transfer pricing audit programs, as also indicated in paragraph 30 of the paper, may be

[5] Paragraph 1.13, OECD TPG.

relieved by personnel exchange in both fields of APA program and transfer pricing audit program between different developing countries.

With regards to **MAP**, it is not included in the double tax treaties signed by many developing countries. The transfer pricing adjustment arising at the end of the audit in many developing countries may relate to transactions involving numerous related parties in numerous countries, some of which may not have double tax treaties in place with the country where the tested company is located, or there is no MAP clauses included in the double tax treaties. For such developing countries, no MAP can be agreed on which will lead to double taxation. Ways shall be identified to address the issue of double taxation for such developing countries.

According to the "Announcement and Report Concerning Advance Pricing Agreement" of March 27th, 2014 by the IRS (Internal Revenue Service of the United States of America (USA))[6] during the year 2013 only 111 APA applications were filed and 145 APA's were completed by the IRS. Despite the fact that as an estimation of the OECD around 60% of world trade actually takes place within multinational enterprises, the IRS report supports the view and practical experience that existing APA programmes have a low practical relevance.

Given the situation that an increasing number of small and medium sized companies are launching businesses in developing countries, small and medium sized companies shall be encouraged to sign more APAs with tax administrations respectively agree upon MAPs to minimize tax compliance risks and uncertainties in transfer pricing. Nevertheless, the sophisticated procedures and high costs tend to keep companies not only in developing countries also in the future away from applying for APAs and MAPs.

For this reason, among others the following steps are recommended to be taken to increase the application of APAs and MAPs for small and medium sized companies:

- acceleration of the proceedings desired;
- standardization of the application processes especially for small and medium sized companies;
- more transparency regulated in the application process; and
- less cost intensive / cost funding for the application process.

F. Conclusion

We appreciate the publication of the Discussion Draft "Transfer Pricing Comparability Data and Developing Countries" as a good contribution of resolving the obstacles appearing with the performance of arm's length comparisons in relation to developing countries.

We like to point out, that in some of the approaches we see a high risk of being non-compliant with the arm's length principal. From our perspective keeping the arm`s length principle is a crucial demand in transfer pricing.

[6] IRS: http://www.irs.gov/pub/irs-drop/a-14-14.pdf.

Among others, we want to raise our concern in respect to:

- Using secret comparables for transfer pricing adjustments;
- Formula-based approaches in the context of income allocation; and
- The sixth method.

In our opinion, the approaches of improving the availability and quality of data, the more effective use of data and guidance on unilateral and multilateral safe harbour rules could be a viable way to improve the situation regarding transfer prices in developing countries.

We furthermore appreciate the fact that several approaches discussed in this draft will address and improve the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively in developed countries as well.

Nuremberg, April 11th, 2014

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